This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 02 SINGAPORE 003027

SIPDIS

E.O. 12958: N/A
TAGS: ECON IN SN
SUBJECT: INDIAN ECONOMY: THE VIEW FROM SINGAPORE

¶1. Summary. On October 15, 2004 visiting Economic Officer Brian Briscombe -- who was wrapping up a week-long trip to Delhi, Mumbai and Hyderabad -- and embassy officers held a series of meetings with private sector analysts to discuss the Indian economy. While all expressed optimism about India,s future prospects, they also acknowledged serious problems, near-term resolution of which will be necessary if India is to continue to grow at its current pace. The Singapore-based analysts identified the financial system, the government deficit, and the lack of political commitment to free market economics as key obstacles to India,s future economic growth. Singapore's trade with India grew 54 percent in the first half of this year -- faster than with any other partner -- and the Singapore government is taking an active approach to boosting trade and investment links. End summary.

Liberalization

¶2. All of the analysts agreed that the GOI needs to further liberalize its trade and investment regimes in order to maintain the country,s current high rate of growth. According to Sailesh Jha of Credit Suisse-First Boston, India is "early cycle," i.e., it is currently experiencing the burst of growth common after the initial introduction of broad based liberalization (similar, he said, to the situation in Southeast Asia in the early to mid-1990s), but it will need to do much more to make high growth rates sustainable. He noted that average tariff rates are still quite high, as is government involvement in the economy. While some technocrats recognize that further liberalization is necessary, politics make adoption and implementation of further reforms difficult. Dominique Dwor-Frecaut of Barclay,s Capital said that no one in India is actively advocating freer markets or more incentives to attract foreign direct investment, because of political sensitivities. While liberalization will continue, it remains a very slow process, she said. Arjuna Mahendran, Chief Economist and Strategist, Credit Suisse, echoed Dwor-Frecaut's sentiments when comparing China's and India's respective economic performance. He noted that, if faced with a choice, Indians would prefer to maintain their current political institutions (and by extension their "more democratic way of life") than to "sacrifice" these in pursuit of more rapid and consistent economic growth (as in the case of China).

¶3. Dwor-Frecaut noted that the rapid rise in importance of India's services sector is not due only to the competitive advantage of its skilled workforce and English language ability, but also because the services sector developed too quickly for bureaucrats to stifle it through over-regulation, as they did with manufacturing. She identified the country's labor laws in particular as a critical area for reform in order to attract FDI in a broader range of sectors. Jha said that India will need to develop its manufacturing sector to create needed jobs, and argued that the idea that India can dominate services and leave manufacturing to China is wrong. China will become increasingly competitive with India on services, he said, as English language skills there continue to improve, and India can compete on manufacturing: it has many of the managerial and technical skills that are increasingly scarce in China.

The Financial System

¶4. All of our interlocutors agreed that the financial sector will constrain future growth. State-owned commercial banks prefer to invest in government debt or government-owned corporations rather than lend to domestic businesses. Sailesh Jha argued that so far, this crowding out of domestic investment has not been a serious problem as domestic firms do have access to external capital sources, although this could change if global demand for emerging market debt dries up. Dwor-Frecaut noted, however, that while larger firms have the option to seek external financing, smaller firms do not. As a result of this lack of access to credit and stifling government regulations, small domestic investors are being forced into the large informal sector. She argued that the GOI will not be able to make needed reforms and privatize the state-owned commercial banks until the government is less dependent on the banks to finance its deficit.

¶5. Van Anantha-Nageswaran of the Libran Fund was more upbeat. He argued that while balance sheets are currently too "healthy" for the public sector banks to be shaken out of their complacency and encouraged to undertake risk-base lending to the private sector, private banks are starting to gain some market share and are doing some risk-based lending to domestic business themselves. While he said the government could be doing more to promote the emergence of private banks, it is happening slowly on its own, injecting a bit more competition into the financial system. This trend is still nascent, he said, but it could ultimately force public banks to rethink their way of operating.

The Fiscal Deficit

¶6. None of the analysts were particularly alarmed about the budget deficit, although they do consider it a vulnerability for the Indian economy in the medium term. Jha said that in the short term (12-18 months) it is "irrelevant," because it is not impinging on the liquidity of the financial system or pushing up interest rates. Both Jha and Anantha-Nageswaran noted that because the mix of government debt is changing -- the GOI relies increasingly on domestically-issued debt and continues to be able to refinance at low interest rates -- there is little chance of an external crisis. Jha and Anantha-Nageswaran also said that the government,s expectations of a shrinking deficit were somewhat unrealistic. Jha said that Delhi,s hope of widening the tax base in the services sector would be difficult to implement, and Anantha-Nageswaran argued that there had been little improvement in the government,s political will to increase tax collection, with most gains in revenue coming from administrative efficiencies rather than policy changes.

¶7. Jha said that the deficit becomes more worrying over the medium term; if inflation continues to pick up and there is no monetary tightening by the government, the deficit could pose a risk to growth. He argued, however, that the government can always spend its considerable reserves in a cash crunch. Anantha-Nageswaran emphasized that the quality rather than the quantity of the deficit is worrisome; if the GOI was spending on infrastructure and education, the deficit would be less worrisome because it would contribute to growth and hopefully a virtuous cycle which would allow India to grow out of the deficit. Instead, India,s infrastructure is famously poor, and the government is spending not on infrastructure and other capital investments, but on the administrative costs of maintaining a large bureaucracy. P.K. Basu, Managing Director, Robust Economic Analysis, similarly lamented the inadequate level of investment in infrastructure, noting that one of the Indian economy's brightest stars -- the software industry centered around Bangalore -- has been so successful in part because it has limited infrastructure investment needs beyond office space, electricity and optical fiber. Other industries, he stressed, are not so lucky.

Comment

¶8. Although they recognize the many challenges for India's economic development, all of the analysts we spoke to believe that India will continue to deliver a high growth story. Their enthusiasm is shared by the Singaporean business community and the government, who hope to capitalize on India's growth and expanding ties to East Asia. India has become Singapore's fastest growing trading partner, with two-way trade increasing by 54 percent in the first half of the year. In typical Singaporean fashion, the GOS is leaving little to chance, and is actively promoting economic links with India, in part to balance out its reliance on ties to the U.S. and China. The GOS hopes to complete negotiations of the Singapore-India Comprehensive Economic Cooperation Agreement by next year, and Temasek, the GOS's investment holding company (run by Ho Ching, wife of Prime Minister Lee Hsien Loong), has become one of India's largest private equity investors, funneling close to $1 billion into the Indian economy in less than a year and opening its first office outside Singapore in Mumbai, according to recent press reports. Not content to be a silent partner, Singapore also offers the GOI plenty of advice. Singapore's Trade and Industry Minister, for example, who is in New Delhi this week to attend the India ASEAN Business Summit, made a speech on October 20 urging India to conclude FTAs with ASEAN countries to quicken its integration with Southeast Asia, and said that the GOI needs to remove non-tariff barriers, adopt mutual recognition of standards and investment guarantee pacts, and streamline new business registration procedures in order to encourage investment.

LAVIN